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CITATIONS

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In the Supreme Court of the United States

October Term, 1947

No. 779

Nate S. Shapero, petitioner

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The prevailing (R. 16–44) and dissenting (R. 45–48) opinions in the Tax Court are reported in 8 T. C. 104. The opinion of the Circuit Court of Appeals (R. 99–109) is reported in 165 F. 2d 811.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 3, 1948 (R. 98). The petition for a writ of certiorari was filed on May 1, 1948. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer, as grantor of three trusts for the benefit of his wife and two children, respectively, is taxable on the income therefrom under Section 22 (a) of the Internal Revenue Code and Section 29.22 (a)–21 (e) of Treasury Regulations 111, as amended.

STATUTE AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*, pp. 17–22.

STATEMENT

The Tax Court found the following facts (R. 17–29):

The taxpayer is an individual residing at Detroit, Michigan. His returns for the years in controversy were prepared on the cash basis and were filed with the Collector of Internal Revenue for the District of Michigan (R. 17).

In 1918, taxpayer founded the Economical Drug Company. This business was operated by him for a time as a sole proprietorship and was later incorporated, with the taxpayer becoming president of the corporation. In 1931, Economical Drug Company was consolidated with Cunningham Drug Company under the name Economical-Cunningham Drug Stores, Inc. The name was later changed to Cunningham Drug Stores, Inc. The corporation will hereinafter be referred to as Cunningham. The taxpayer has always been

president and a director of Cunningham. Salaries and other compensation for personal services received by taxpayer in the calendar years 1940 and 1941 were reported by him on his tax returns as $44,999.92 and $59,999.92, respectively. The stock of Cunningham was listed on the Detroit and Chicago Stock Exchanges throughout the tax years here in question. (R. 17–18.)

The taxpayer's family consists of his wife, Ruth Bernstein Shapero, a son, Raphael August, born in 1926, and a daughter, Marianne, born October 1, 1930 (R. 18).

Under date of December 6, 1934, by separate instruments, the taxpayer created three trusts, one each for the benefit of his wife, his son and his daughter. Each trust was amended by a separate instrument under date of December 29, 1936. In each trust, the taxpayer was named as "individual Trustee" and Detroit Trust Company as "corporate Trustee." (R. 18.)

The trusts for the benefit of the taxpayer's children were identical. Paragraph 2 of the children's trusts, as typified by the trust for the benefit of the taxpayer's son, provided in part as follows (R. 18–19):

> 2. The trust hereby created shall be for the use and benefit of Grantor's son, RAPHAEL AUGUST SHAPERO. The net income of the trust estate shall, during the minority of Grantor's said son, be accumulated and added to the corpus of the

> trust with power in the Trustees to apply out of such accumulations or the corpus a suitable sum from time to time for the maintenance and education of such minor if such minor by reason of the death or incapacity of the Grantor or of other cause whatsoever shall have no other sufficient means therefor and with power in the individual trustee during his lifetime to direct the paying out of any such accruing or accumulated income for the benefit of such minor in any way which the Grantor as parent of said minor is not under obligation in law to provide. From and after the time Grantor's said son, RAPHAEL AUGUST SHAPERO, shall arrive at the age of twenty-one (21) years, the Trustee shall pay to him the entire net income from the trust estate during the continuance thereof, unless the individual trustee during his lifetime, or the successor individual trustee, as the case may be, shall otherwise direct; *Provided, However,* that in no event shall the Grantor, either as an individual or Trustee hereunder, be entitled to receive any of the income or the accumulations thereof derived from the trust estate created herein.

The trustees were directed to distribute the trust corpus to the beneficiary in varying amounts, beginning when he or she reached the age of thirty and ending when the beneficiary reached the age of forty-five, at which time all the rest, residue and remainder of the trust

estate was to be paid over to the beneficiary, free and discharged from the trust. In the event any beneficiary died before becoming entitled to receive the trust corpus, provisions were made in favor of the beneficiary's issue or, if none, for the taxpayer's other children and their issue. (R. 19.)

The trust for the benefit of the taxpayer's wife provided that after paying necessary expenses, the trustees should distribute the entire net income therefrom to the beneficiary at such times and in such amounts as the individual trustee (taxpayer) should direct during his lifetime and after his death as the successor individual trustee should direct, and after the death of such successor individual trustee, as the beneficiary should direct, unless and until she should remarry, at which time her power to direct the payment or use of the net income should cease and determine. Any income not disbursed was to be accumulated and retained as cash or invested and distributed at a later date, in the discretion of the individual trustee. In the event the taxpayer's wife should remarry after his death, the trustees were directed to set aside one-third of the then corpus of the trust estate in a separate trust for her use and benefit and to hold the remaining two-thirds in equal shares for the benefit of the taxpayer's children, to be administered in the same manner as that provided in the trusts for their benefit. Upon the death of the taxpayer's wife, the entire

corpus of the trust was to be held in equal shares for the benefit of the taxpayer's children as aforesaid. (R. 20.)

Provision was made in each of the trusts for invasion of the corpus upon direction by the individual trustee or his successor if, in the opinion of the individual trustee, or his successor, the income of the trust was insufficient to support and maintain the grantor's wife and to furnish her with funds for reasonable travel and recreation, or if it was insufficient to support, maintain and educate the grantor's children, including a college, university or finishing school education, or in case of any emergency befalling any beneficiary, such as illness, accident, or extraordinary financial distress. It was provided, however, that during the lifetime of the grantor no part of such principal should ever be used to satisfy any legal obligation of the grantor toward such beneficiary or to relieve the grantor therefrom. (R. 20–21.)

Material provisions, common to all the trusts, as typified by those in the Ruth Bernstein Shapero trust, may be summarized as follows (R. 21–27):

The grantor was given the power to modify, alter or amend the agreement in whole or in part so long as the change did not work a revocation, change or impair the right of enjoyment of any beneficiary, or revest in the grantor title to any part of the corpus or income (R. 21). The text of this provision is quoted *infra,* pp. 12–13. The trustees were authorized to retain any property,

whether or not it constituted a legal investment (R. 22–23), and to dispose of all property "upon such terms as in the absolute and uncontrolled discretion of the individual Trustee, or the successor individual Trustee as the case may be, shall deem expedient and proper" (R. 23). After specifically granting to the individual trustee or his successor the powers to designate forms of investment of trust assets, to direct sales and fix prices of any trust property, to distribute in kind to the persons entitled to participate any stocks, bonds, or other securities in the trust estate at a price to be fixed by the individual trustee, or his successor, all in his "sole and uncontrolled judgment and discretion" (R. 23–24), the trust instrument recited that (R. 25):

> (j) It is Grantor's intention to give the individual Trustee during his lifetime, and after his death to the successor individual Trustee, the fullest and most complete powers and authority which it is possible for Grantor to give in respect of all sales, investments, expenditures, management and control of the trust property and estate; provided, always that no power herein given to the individual Trustee shall ever be interpreted or construed as a power giving the Grantor the right to revest in himself title to any of the trust property and estate or the income produced therefrom.

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In addition, the individual trustee or his successor was granted authority, at any time, to direct the payment of corpus or accumulated income to the then living beneficiary or beneficiaries in such proportions as he may think proper (R. 26), and to remove the corporate trustee, fill the vacancy or leave the vacancy unfilled (R. 26–27).

The original corpus of the Ruth Bernstein Shapero trust consisted of 20,000 shares of the stock of Cunningham. The original corpus of each of the other two trusts consisted of 672 shares of Cunningham stock. In 1937, 10,300 shares of Cunningham stock were sold from the Ruth Bernstein Shapero trust and the proceeds were invested in other stocks and securities. The other 9,700 shares are still held in the trust. The taxpayer from time to time contributed additional shares of the stock of Cunningham to the children's trusts, the last such contribution being in 1938. A purchase was also made by the children's trusts of shares of Ray Mar Corporation, the assets of which consisted wholly of Cunningham shares. Throughout the years here in controversy each of the children's trusts held 7,092 shares of Cunningham, as well as other stocks and securities. (R. 27.)

During 1940 to 1941, there were 190,798 shares of stock of Cunningham outstanding. In 1940, 104,279 shares were voted and in 1941, 104,660 shares were voted. Of the amounts so voted the percentage of shares voted by the Shapero inter-

ests, including the amounts held in the trusts, was 60.64 percent in 1940 and 59.85 percent in 1941. (R. 27–28.)

All shares of stock and other registered securities in the trusts were held in the name of "Nate S. Shapero & Detroit Trust Company, Trustees u/a, dated December 6, 1934, for the benefit of [name of beneficiary]." All securities were held in the physical possession of the corporate trustee. The funds of the trust are carried by the corporate trustee in its general fiduciary account for all trusts administered by it. The shares of Cunningham stock held in the trusts were voted by an officer of the corporate trustee at the stockholders' meetings of Cunningham in each of the years 1936 to 1941, both inclusive, under proxies granted by the trustees. In making sales of securities and in making investments, such transactions have, in most cases, been passed upon by the investment committee of the corporate trustee, as well as by the taxpayer as individual trustee. Such transactions were usually originated by some officer or employee of the corporate trustee. No loan of cash or securities has ever been made out of any of the trusts to or for the account of the taxpayer, nor has he ever requested such a loan. (R. 28.)

Of the net income for 1940 from the trust for the benefit of the taxpayer's wife, the sum of \$1,767.15 was distributed to her in that year. Of the income for 1941, \$1,767.15 was distributed to

her in that year. None of the income of the children's trusts has been distributed but all has been retained and invested. (R. 28.)

Returns were filed for the years in question by the taxpayer, his wife, and each of the three trusts. The taxes shown to be due thereon were paid. In his individual returns for 1940 and 1941, the taxpayer reported net income in the respective amounts of $88,401.76 and $97,865.87. (R. 29.)

Net incomes taxable to the fiduciary were reported as follows by the three trusts (R. 29):

	1940	1941
Trust for wife	$13,031.13	$14,345.14
Trust for son	7,116.28	8,955.00
Trust for daughter	7,140.28	9,011.70

In October 1944, consents, signed respectively by the taxpayer as grantor, and by the trustees, were filed with the respondent in conformity with the requirements of Section 134 (b) (2) of the Revenue Act of 1943 (R. 29).

The Commissioner taxed to the grantor the income of the three trusts for the years 1940 and 1941 (R. 9, 11, 17) and the Tax Court held such action correct (R. 44). The Circuit Court of Appeals affirmed (R. 109).

ARGUMENT

Both of the courts below held, correctly, we submit, that the taxpayer is accountable under Section 22 (a) of the Internal Revenue Code

(Appendix, *infra,* p. 17) and *Helvering* v. *Clifford,* 309 U. S. 331, for the income of the three trusts that he created for the benefit of his wife and two children, respectively.

The Tax Court based its decision upon the conclusion (R. 44) that the rights retained by taxpayer and the benefits enjoyable by him were such that there was no substantial change in his economic position as a result of the transfers in trust, and, hence, that the case is within the purview of the *Clifford* doctrine. The Tax Court thought it unnecessary to consider the regulations (R. 44) and reached its conclusion without regard to them.

In affirming, the Circuit Court of Appeals said (R. 100) that it thought that the majority opinion in the Tax Court was sound and would affirm on its rationale were it not for the problem as to the application of the new *Clifford* regulations (Sec. 29.22 (a)–21 of Treasury Regulations 111, as amended (Appendix, *infra,* pp. 18–22) which required consideration. The Court of Appeals then proceeded to consider the regulation in the light of the facts presented and concluded, correctly, we submit, that it supports the tax.

1. The new *Clifford* regulation is by its terms applicable only to taxable years beginning after 1945. Consequently, in this case, whatever tax liability there may be must be found in the law as its existed before the new regulation. In this aspect of the case, the Tax Court's opinion is,

we think, plainly correct and, since a case such as this must depend upon its own peculiar facts, no problem worthy of consideration by this Court is presented.

That this is not a case for certiorari is a conclusion rendered no less true by the fact that it is the policy of the Treasury not to assert the tax in years beginning before 1946 with respect to cases not yet finally determined if the new regulation would, if applicable, relieve the taxpayer of liability. See Mim. 6156, 1947–2 Cum. Bull. 13. Moreover, it is clear that in the instant case, as held by the court below, the regulation does not help the taxpayer and he remains accountable for the tax.

The critical provisions of the regulation are found in paragraph (e) and they were the ones relied upon by the Circuit Court of Appeals in sustaining the tax. See Appendix, *infra*, pp. 19–21. These provisions cover cases where under the terms of the trust or the circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. In the instant case, paragraph 1 of each indenture, as amended, provides as follows (R. 21):

> 1. The Grantor shall have the power at any time during his lifetime, by an instrument in writing delivered to the Trustees, to modify, alter, change or amend this agreement in whole or in part, but not in

> such manner as to bring about a revocation of this agreement or to change or impair the right of enjoyment of any beneficiary, and provided, further, that Grantor shall not have the power at any time during the continuance of the trusts hereof to revest in himself title to any part of the corpus or income of the trust hereby created.

This provision would seem to enable the grantor to vest in himself, individually, any and all types of administrative control over the trusts so long as the rights of enjoyment of the beneficiaries are not altered. It might, for example, permit the grantor to provide that the trust funds should be loaned to him with or without security or interest whenever he should request such a loan. And under paragraph (e) (2) of the new regulation, such an untrammelled power to borrow is considered as a type of administrative control exercisable primarily for the benefit of the grantor. We submit that there is good reason for the provision, and where the grantor can borrow the trust funds at his pleasure and use them for his own purposes, it can make little difference from the tax standpoint that the trust instrument contains no provision for reversion to the grantor and the trust funds are unimpaired.

Moreover, paragraph 1 of the trust instruments, above quoted, has a direct bearing upon the taxpayer's power to vote the shares of stock in the trusts and it should be considered in connection

therewith. Each trust held shares of stock in a corporation of which the taxpayer was the president and a director and principal stockholder, and the stock was listed on the Detroit and Chicago Stock Exchanges. It seems clear that the grantor, fortified by his rights under paragraph 1 of the trust instruments, could have exercised in a nonfiduciary capacity his right to vote the stock placed in trust; and hence the regulation justifies the tax. See paragraph (e) (4), Appendix, *infra*, pp. 20–21. And see *Helvering* v. *Fuller*, 310 U. S. 69, 72, 76; *Helvering* v. *Stuart*, 317 U. S. 154, 169; *Commissioner* v. *Sunnen*, decided April 5, 1948, No. 227, this Term.

Although, as above noted, the Tax Court did not pass on the regulation, it concluded in its opinion (R. 33, 43) that the taxpayer's reserved powers could have been utilized for his own economic benefit. And the Circuit Court of Appeals, applying the regulation, reached a similar conclusion. (R. 107.)

2. In support of his application for certiorari, the taxpayer contends (Pet. 10, 11, 27) that the instant decision is in conflict with the decision of the Second Circuit Court of Appeals in *Cushman* v. *Commissioner*, 153 F. 2d 510. We submit that no such conflict exists, although it does seem that under the *Dobson* rule (*Dobson* v. *Commissioner*, 320 U. S. 489), the Circuit Court of Appeals should not have reversed the decision of the Tax Court in the *Cushman* case. That case as well

as the others cited by the taxpayer on page 11 of his petition for certiorari (*United States* v. *Morss*, 159 F. 2d 142 (C. C. A. 1st); *Welch* v. *Commissioner*, 8 T. C. 1139) did not deal with the new regulation and are distinguishable from the instant case because the grantors there did not have powers equivalent to those retained by the grantor here authorizing him to amend the trust so as explicitly to permit a non-fiduciary exercise of powers for his own purposes. Moreover, it does not appear in those cases that the grantor's power to vote the trusteed shares had as much bearing on his actual control of the company in the taxable years as it had here. Here the Tax Court concluded (R. 42) that "it was through the trusts that petitioner had control of more than 50 per cent of the voted stock." The situation in the instant case is analogous to the one in *Helvering* v. *Fuller, supra,* 310 U. S. 69, 72, 76, where this Court explicitly pointed out that such considerations are of importance in determining taxability under the *Clifford* rule.

It is true that the *Stockstrom* case (*Stockstrom* v. *Commissioner,* 148 F. 2d 491 (C. C. A. 8th), certiorari denied, 326 U. S. 719, on remand, 7 T. C. 251), referred to by the taxpayer (Pet. 17), was eventually settled so as not to tax to the grantor the income from the seven trusts for the grandchildren, and this adjustment was made in the light of the amended regulation; but that case is distinguishable because there the grantor did not

have administrative control comparable to that of the taxpayer here.

As we have said, the instant decision turns on the construction of the peculiar provisions of the trusts and the circumstances attendant on their operation. Although the Circuit Court of Appeals considered the new regulation and the Tax Court did not, the two decisions are in other respects harmonious and consistent and in the circumstances there is believed to be no adequate basis for further review by this Court.

CONCLUSION

The decision is correct; there is no conflict; and the petition should be denied.

Respectfully submitted.

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MAY, 1948.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real of personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U. S. C. 1940 ed., Sec. 22.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)-1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be under-

stood to include profit gained through a sale or conversion of capital assets. * * *

* * * * *

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.22 (a)–21 [as added by T. D. 5488, 1946–1 Cum. Bull. 19, and amended by T. D. 5567, 1947–2 Cum. Bull. 9]. TRUST INCOME TAXABLE TO THE GRANTOR AS SUBSTANTIAL OWNER THEREOF.—(a) *Introduction.*—Income of a trust is taxable to the grantor under section 22 (a) although not payable to the grantor himself and not to be applied in satisfaction of his legal obligations if he has retained a control of the trust so complete that he is still in practical effect the owner of its income. (*Helvering* v. *Clifford,* 309 U. S. 331.) In the absence of precise guides supplied by an appropriate regulation, the application of this principle to varying and diversified factual situations has led to considerable uncertainty and confusion. The provisions of this section accordingly resolve the present difficulties of application by defining and specifying those factors which demonstrate the retention by the grantor of such complete control of the trust that he is taxable on the income therefrom under section 22 (a). Such factors are set forth in general in paragraph (b) and in detail in paragraphs (c), (d), and (e), below.

(b) *In general.*—In conformity with the principle stated in paragraph (a) above, the income of a trust is attributable to the grantor (except where such income is taxable to the grantor's spouse or former spouse under section 22 (k) or 171) if—

(1) the corpus or the income therefrom

will or may return after a relatively short term of years (see paragraph (c));

(2) the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition (other than certain excepted powers), whether by revocation, alteration, or otherwise, exercisable by the grantor, or another person lacking a substantial adverse interest in such disposition, or both (see paragraph (d)); or

(3) the corpus or the income therefrom is subject to administrative control, exercisable primarily for the benefit of the grantor (see paragraph (e)).

* * * * *

(e) *Administrative control.*—Income of a trust, whatever its duration, is taxable to the grantor where, under the terms of the trust or the circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. Administrative control is exercisable primarily for the benefit of the grantor where—

(1) a power exercisable by the grantor, or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the grantor or any person to purchase, exchange or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate and full consideration in money or money's worth; or

(2) a power exercisable by the grantor, or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the

grantor to borrow the corpus or income, directly or indirectly, without adequate interest in any case, or without adequate security except where a trustee (other than the grantor or spouse living with the grantor) is authorized under a general lending power to make loans without security to the grantor and other persons and corporations upon the same terms and conditions; or

(3) the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year; or

(4) any one of the following powers of administration over the trust corpus or income is exercisable in a nonfiduciary capacity by the grantor, or any person not having a substantial adverse interest in its exercise, or both: a power to vote or direct the voting of stock or other securities, a power to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and a power to reacquire the trust corpus by substituting other property of an equivalent value.

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Such presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether such power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of

the trust and the circumstances surrounding its creation and administration. For example, where the trust corpus consists of diversified stocks or securities of corporations the stock of which is not closely held and in which the holdings of the trust, either by themselves or in conjunction with the holdings of the grantor, are of no significance from the viewpoint of voting control, a power with respect to such stocks or securities held by a person who is not a trustee will be regarded as exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Where the trust corpus consists of stock or securities of a closely held corporation, such a power may or may not, depending upon all the facts, be considered exercisable in a fiduciary capacity.

The mere fact that a power exercisable by the trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

(f) *Limitations of section.*—Despite the limitations of this section, the grantor of a trust directing the payment or application of the income therefrom in satisfaction of the grantor's legal obligations shall continue to be taxable on the income. The grantor may also be taxable on the income of a trust on the ground that such income is attributable to him in a capacity unrelated to dominion and control over the

trust as such as defined in subsections (c), (d), and (e) of this section. Thus, the provisions of this section do not affect the principles governing the taxability of future income to the assignor thereof whether or not the assignment is by means of a trust. Nor, for example, do the provisions of this section affect the applicability of section 22 (a) to the creator of a family partnership. See further sections 166 and 167.

Section 22 (a) shall be applied in the determination of the taxability of trust income for taxable years beginning prior to January 1, 1946, without reference to this section.

U. S. GOVERNMENT PRINTING OFFICE: 1949